Original

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
1998 Biennial Regulatory Review --	)	CC Docket No. 98-137
Review of Depreciation Requirements	)	
for Incumbent Local Exchange Carriers	)	
	)	

COMMENTS OF THE AD HOC TELECOMMUNICATIONS USERS COMMITTEE

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The Ad Hoc Committee (hereinafter "Ad Hoc" or "the Committee") hereby responds to the Federal Communications Commission's (the "Commission") October 14, 1998, Notice of Proposed Rulemaking ("NPRM") in the above-captioned proceeding. The NPRM seeks comment on proposals which would change the Commission's depreciation prescription process to permit summary filings and eliminate the prescription of depreciation rates for Incumbent Local Exchange Carriers ("ILECs"), provided an ILEC uses depreciation factors within the ranges adopted by the Commission.[1] ILECs also would be allowed to set their own depreciation rates if they are willing to waive the automatic low-end adjustment.[2] Pursuant to the Commission's October 16, 1998 Public Notice, Ad Hoc also hereby responds to the Commission's

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1 *In the Matter 1998 Biennial Regulatory Review -- Review of Depreciation Requirements for Incumbent Local Exchange Carriers*, Notice of Proposed Rulemaking, CC Docket No. 98-137, (rel. Oct. 14, 1998) at para 4.

2 *Id.*

earlier Public Notice issued September 29, 1998 seeking comment on a related petition filed by the United States Telecommunications Association ("USTA") urging the Commission to forbear from regulating the depreciation and amortization practices of local exchange carriers ("LECs") subject to price cap regulation.

As set forth in these comments, the Ad Hoc Committee is not opposed in principle to the deregulation of depreciation and amortization practices of price cap LECs. However, such deregulation must be accompanied by the elimination of regulatory guarantees for recovery of LEC embedded investment remaining under price cap regulation, such as the low-end adjustment or the ability to seek recovery of depreciation reserve deficiencies. Ad Hoc's position is consistent with the "Make Whole or Make Money" framework proposed by the Committee in numerous other Commission proceedings, most recently in response to the Commission's October 5, 1998 Public Notice inviting parties to refresh the record in the Access Charge Reform and Price Cap Performance Review proceedings, CC Dockets Nos. 96-262 and 94-1. If LECs want freedom to set their depreciation rates as unregulated companies do, they must accept the same level of economic risk that unregulated companies face.

SUMMARY

The NPRM wisely recognizes the dangers of premature deregulation of depreciation for price cap LECs in a market environment not yet sufficiently competitive to constrain their depreciation practices.[3] Appropriately, the NPRM focuses on the linkage between any such deregulation and the conditions which would need to be

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[3] *Id.* at para. 7.

adopted in order to protect the public interest in the absence of full competition. The Ad Hoc Committee urges the Commission to adhere to the tentative conclusions set forth in the NPRM, namely that the elimination of depreciation regulation would have adverse impacts in several critical areas, and that unless specific conditions are implemented concomitant with the reduction of such regulation, the public interest will not be served.[4]

In response to the NPRM, Ad Hoc proposes a set of conditions the Committee believes are necessary if the public interest is to be served by the elimination, or significant reduction, of depreciation regulation for price cap LECs at this time. These conditions include:

- elimination of the low-end adjustment mechanism; and
- mandating that LECs forego the opportunity to seek special recovery of depreciation reserve deficiencies or assertion of any takings claim under the Fifth Amendment.

By contrast, USTA's proposal, which the Ad Hoc Committee strongly opposes, would impose no conditions whatsoever on the price cap LECs. USTA's proposal would allow price cap LECs the same freedom to set depreciation rates as afforded their unregulated competitors, while at the same time preserving for the LECs guaranteed investment recovery and above-market pricing -- economic privileges that are simply unavailable in a competitive market environment.[5] Thus, the USTA petition

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[4] *Id.* at para. 19.

[5] This same argument would apply to the SBC proposal to set depreciation rates based on GAAP, as cited in NPRM at para. 19.

seeks to obtain for the price cap LECs the best of both worlds. If adopted, USTA's petition would provide price cap LECs an unprecedented opportunity for windfall gains that would come at the expense of the LECs' access charge customers and end users, who remain to this day without viable competitive alternatives for many components of the LECs' services.

The risk of unjustifiably higher prices faced by consumers as a result of the requested forbearance — through, for example, utilization of the low-end adjustment mechanism, or through individual price cap LECs' requests to recover depreciation reserve deficiencies, or through higher universal service support mechanisms or higher rates for unbundled network elements — far outweighs the potential benefits USTA alleges consumers would receive from the efficiency-enhancing aspects of forbearance. Contrary to USTA's position, forbearance from depreciation regulation of price cap LECs — in the absence of other conditions limiting the ability of price cap LECs to use depreciation forbearance as a means of achieving higher prices — is not in the public interest and therefore is specifically not mandated under Section 10 of the Communications Act.[6]

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[6] *See* United States Telephone Association, Petition for Forbearance from Regulation of Depreciation and Amortization Practices of Local Exchange Carriers to Price Cap Regulations, (filed Sept. 21, 1998) at 2. ("USTA Petition")

I. THE COMMISSION CORRECTLY RECOGNIZES THE EXISTENCE OF AN IRREFUTABLE LINK BETWEEN DEPRECIATION RATES AND A LEC's CHARGES UNDER PRICE CAP REGULATION.

The Commission's Notice describes no less than seven situations in which depreciation remains significant under price caps regulation. These pertain to:

(1) the calculation of a low-end adjustment;

(2) the recalculation of the productivity factor;

(3) the determination of an exogenous cost adjustment;

(4) the calculation of the Base Factor Portion that is used to determine how much a carrier can recover through End User Common Line charges;

(5) the determination of the cost support a carrier would have to provide if it proposed an Actual Price Index higher than its Price Cap Index;

(6) the effects on prices or federal support payments in connection with new mechanisms created to implement the Telecommunications Act of 1996, for example, in the determination of forward looking costs used for calculating universal service support or rates for interconnection and unbundled network elements; and

(7) takings claim under the Fifth Amendment.[7]

Ad Hoc agrees with the Commission that the situations listed above are areas in which depreciation has a significant impact on price cap LECs, thereby establishing an irrefutable link between depreciation rates and a LEC's charges under price cap regulation. The Commission's thoughtful analysis of the link between costs via depreciation rates and prices remaining under price cap regulation is in sharp contrast to the rhetoric found in USTA's petition.

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[7] NPRM at para. 6.

According to USTA, the "only remaining link between reported costs and prices in interstate price cap regulation is the low-end adjustment mechanism, under which a LEC may make a one-time upward adjustment to its price cap indices if its reported rate of return falls below 10.25%."[8] USTA is blatantly wrong. As the NPRM demonstrates, there are several remaining links between prices and costs in price cap regulation.

Incredibly, even with respect to the one link USTA itself is unable to ignore, USTA does not propose the only reasonable solution, namely the requirement that any LEC subject to forbearance from depreciation regulation agree to forego the low-end adjustment mechanism. Instead, USTA argues that the Commission should effectively ignore the issue of the low-end adjustment mechanism on the grounds that it was "rarely evoked in the past."[9] This argument is completely without merit, since the rarity with which the low-end adjustment may have been evoked in the past is irrelevant to the new-found ability of a price cap LEC to manipulate depreciation rates under a regime of forbearance for the express purposes of evoking the adjustment.

It is quite telling that individual LECs have implicitly acknowledged the weakness in USTA's argument by themselves proposing the elimination of the low-end adjustment in exchange for forbearance from depreciation regulation.[10] However, as recognized by the Commission, this single condition, while certainly necessary, is not sufficient to

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[8] USTA Petition at 12.

[9] *Id.* at 12. USTA offers the lame provision that "if a price cap LEC seeks to implement a low-end adjustment after forbearance takes effect... the LEC should be responsible for demonstrating, at the Commission's staff's request, that the LEC's depreciation practices are reasonable and did not distort the LEC's reported earnings."

[10] NPRM at para. 8, citing Presentation from Kathleen B. Levitz, BellSouth, to Ruth Milkman, FCC (Apr. 8, 1998).

protect the public interest from the potential harm from forbearance, because it only addresses one out of the multiple situations found by the Commission where linkages between depreciation and ILEC rates remain.[11]

II. THE COMMISSION SHOULD NOT ALLOW LECs TO USE DEPRECIATION RESERVE DEFICIENCIES AS A CONDITION AFFECTING ACCESS CHARGES.

In the NPRM, the Commission enunciates a number of irrefutable conclusions: first, the local exchange market is not robustly competitive today; second, as a consequence, the competitive market cannot be counted on to constrain the LEC's ability to cover higher depreciation rates; and third, the elimination of the depreciation prescription process will therefore have adverse impacts on LEC customers absent the imposition of specific conditions that address each of the areas in which depreciation remains inextricably linked to ILEC charges.[12]

Of the situations identified in the NPRM as areas where depreciation has a significant impact, perhaps the greatest exposure end users would face from the deregulation of depreciation is the LECs' ability to assert claims under the Fifth Amendment. Ad Hoc is particularly concerned about claims by individual price cap LECs to recover depreciation reserve deficiencies based upon depreciation rates unilaterally set by the LEC under the new forbearance regime.

USTA's petition could not have made more clear the intentions of price cap LECs to make such claims. USTA states:

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[11] *See Id.* at para. 6, in which situations where depreciation remains a significant factor are enumerated.

> When forbearance takes effect, individual price cap LECs should not be precluded from making their cases for recovery of any depreciation reserve deficiencies that may exist.[13]

Although, under the Commission's prescribed depreciation rates, there is no apparent depreciation reserve imbalance,[14] that is not the case under the LECs' notion of economic depreciation. According to USTA's filing in the Commission's access charge reform proceeding, if given flexibility to set their own depreciation rates, ILECs could be seeking potential recovery of a depreciation reserve deficiency of as much as $4.48 billion in the interstate jurisdiction ($17.9-billion on an unseparated basis).[15] The interstate amount represents roughly 20-25% of total interstate access charges.

In that filing, USTA specifically proposed that the Commission "permit price cap LECs to recover the reserve deficiency" by "bill[ing] IXCs a *pro-rata* amount to recover the reserve deficiency over an accelerated recovery period."[16] USTA acknowledged that "[t]his, of course requires additional revenues over the recovery period."[17] Indeed, over the five year recovery period proposed by USTA, this works out to some $897 million per year that USTA would have the Commission assess IXCs based on their

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12 *Id.* at para. 7.

13 USTA Petition at 2, 18-19.

14 NPRM at para. 17, n. 48.

15 *In the Matter of Access Charge Reform, CC Docket No. 96-262, Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Transport Rate Structure and Pricing, CC Docket No. 91-213, and Usage of the Public Switched Network by Information Service Providers and Internet Access Providers, CC Docket No. 96-263,* Comments of the United States Telephone Association (Jan. 29, 1997) at 72. ("USTA Comments")

16 *Id.* at 75.

17 *Id.*

share of interstate revenues.[18] To be sure, these "additional revenues over the recovery period" ostensibly assessed on IXCs would ultimately have to be recovered from end users. Thus, there is compelling evidence that granting ILECs flexibility in setting their own depreciation rates could have a severe adverse impact on end users.

The only way to protect against this potentially severe adverse impact is to preclude ILECs, as a condition of being allowed the flexibility to set their own depreciation rates, from pursuing recovery of depreciation reserve deficiencies or other takings claims based upon unilaterally set depreciation rates. Unless individual price cap LECs waive claims for recovery of depreciation reserve deficiencies, forbearance from depreciation regulation will afford LECs the opportunity to charge excessive prices for access charge services.

Indeed, even the Commission's more limited proposals to streamline the filing process for price cap LECs[19] may have an adverse impact on end users if LECs pursue a takings claims. Permitting the ILECs to submit only summary filings, or no filings at all, will greatly hinder the ability of other parties to effectively rebut ILEC takings claims. For example, a study by Economics and Technology, Inc., submitted in the Commission's Access Charge Reform proceeding specifically responding to ILEC claims to special revenue recovery mechanisms for embedded investment, relied upon Commission depreciation filings in evaluating the gap between embedded and forward looking costs.[20] The study relied in particular on generation arrangement tables

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18 *Id.* at 76.

19 NPRM at para. 10.

20 Patricia D. Kravtin and Lee L. Selywn, *Assessing Incumbent LEC Claims to Special Recovery*

provided by the ILECs to the FCC as part of their triennial depreciation filings as the source for survivorship percentages by plant vintage.[21] This information was critical to the study's finding that the bulk of ILEC historic net book investment (as of the end of 1996) for which the ILECs were seeking special recovery mechanisms was acquired "after ILECs were well aware of impending changes in market and regulatory environments and entirely capable of managing their construction and investment programs to accommodate such changes," and could not be explained by growth in basic service demand.[22] Similarly, the Commission's proposal to eliminate the requirement that mid-size LECs file theoretical reserve studies[23] may also have an adverse impact, since if such studies are not filed, there would appear to be no benchmark for comparing estimates of depreciation reserve deficiencies calculated by the ILECs' on the basis of their unilaterally set depreciation rates and the reserve deficiencies under prescribed rates.

One of the arguments put forth by USTA in support of forbearance is that "by forbearing from regulating the practices of the price cap LECs, the Commission will end for these carriers the history of costly, massive filings and contentious debates that have characterized the regulatory depreciation process through the years."[24] However,

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Mechanism: Revenue Opportunities, market assessments, and further empirical analysis of the "Gap" between embedded and forward-looking costs, In the Matter of Access Charge Reform, CC Docket No. 96-262, January 29, 1997 (submitted as attachment to AT&T Comments).

21 *Id.*, Appendix A (*Analysis of Incumbent LECs: An Empirical Perspective on the "Gap" between Historic Costs and Forward-Looking TSLRIC*, May 30, 1996, p.10.

22 *Id.* at 12-14.

23 *Id.* at 17.

24 USTA Petition at 18.

unless and until the ILECs forego the possibility of takings claims, the resolution of which will be inextricably tied to discussion of the ILECs' depreciation practices, there can be no end to contentious debates in this area. While a streamlining of filing requirements may result in less massive filings for the Commission to contend with, if the ILECs are allowed to proceed with takings claims, it will have been accomplished at the potential expense of parties seeking mitigation of ILECs' claims.

III. AD HOC's "MAKE WHOLE OR MAKE MONEY" PROPOSAL AND ILECs PROPOSALS TO BE SUBJECT TO GAAP PRINCIPLES ARE CONSISTENT AND WOULD PRECLUDE RBOCs FROM USING DEPRECIATION FLEXIBILITY UNFAIRLY.

The NPRM's concluding paragraph, seeks comment on "SBC's alternative proposal that depreciation rates for price cap carriers should be based on 'economic analysis consistent with the procedures called for by Generally Accepted Accounting Principles ("GAAP").'"[25] Ad Hoc is not opposed in concept to the ILECs' use of "economic analysis consistent with procedures called for by GAAP" in setting depreciation rates. However, to the extent ILECs are permitted to adopt depreciation rate setting procedures called for by GAAP, it is only fair that they be required to adopt GAAP procedures across the board.

Of particular significance is the GAAP procedure that calls for write-offs or write-downs of obsolete or non-performing assets, which the LECs themselves did in connection with action they took in regard to the discontinuance of SFAS 71

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[25] NPRM at para. 19.

(regulatory) accounting in the early to mid-1990's for purposes of financial reporting records.[26] Significantly, at the time the ILECs elected to discontinue SFAS 71 accounting for financial reporting purposes, they argued that, inasmuch as they (according to the ILECs) no longer enjoyed a monopoly position, they can no longer be assured of the ability to recover its investments and earn a return thereon; hence, they could no longer report under SFAS 71.[27] Moreover, upon conversion to GAAP, they took certain write-offs and write-downs in the range of $20-billion in order to reflect an erosion of asset values and shorter depreciation lives that were not required under SFAS 71.[28]

If the ILECs were somehow allowed to be recover the depreciation reserve deficiency resulting from the conversion to GAAP depreciation, that event would itself be contradicted by the arguments raised by the ILECs in abandoning SFAS 71 to begin

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[26] SFAS 71 is used for companies whose revenues are based upon cost and are protected against loss of revenue through an ongoing regulatory system. SFAS 71 companies are expected to recover their capital investments in plant and other fixed assets, and to earn a reasonable and predictable return thereon. Since authorized revenues are based upon the net book value of the company's assets (its "rate base") and not specifically upon the extent to which any individual asset or group of assets produces revenue, SFAS 71 companies are not expected to take any write-offs or write-downs of obsolete or non-performing assets. Even though revenue recovery and return on investment is not *per se* guaranteed by the regulatory agency, the utility is expected to be financially capable of generating the allowed revenue level by virtue of its monopoly status in the market for its services.

[27] *See, e.g,* Bell Atlantic – Washington, D.C., Inc. Form 10-K, for the fiscal year ending December 31, 1994 describing the discontinuance of regulatory accounting principles:

> The Company's determination that it was no longer eligible for continued application of the accounting required by Statement No. 71 was based on the belief that the convergence of competition, technological change (including the Company's technology deployment plans), actual and potential regulatory, legislative and judicial actions, and other factors are creating fully open and competitive markets. In such markets, the Company does not believe it can be assured that prices can be maintained at levels that will recover the net carrying amount of existing telephone plant and equipment, which has been depreciated over relatively long regulator-prescribed lives. In addition, changes from cost-based regulation to a form of incentive regulation contributed to the determination that the continued application of Statement No. 71 is inappropriate.

[28] This figure is based upon a review of RBOC Annual 10-K filings for the years 1993 to 1995.

with, since it would constitute the very type of assured cost recovery that SFAS 71 (but not GAAP) is intended to accommodate. Companies subject to GAAP reporting are afforded no such protection either of their asset base and the recovery thereof, or of any "monopoly" control over the market that each GAAP firm serves. If an asset no longer produces revenue or has become economically and/or technologically obsolete, a GAAP company is expected to take a write-off or write-down of the asset's value as a charge against shareholder earnings. GAAP companies facing increased depreciation resulting from the shorter economic lives recover capital either through expense savings and/or revenue increases as permitted by the market. Guaranteed recovery of "depreciation reserve deficiencies" is simply not part of the package.[29]

Ad Hoc once again recommends the Commission adopt policy consistent with Ad Hoc's "Make Whole or Make Money" framework. Under Ad Hoc's Whole or Make Money" framework, ILECs would be allowed to choose between a "make whole" option of guaranteed recovery of their embedded accounting costs, including the excess above economic cost levels, but under Commission oversight of their earnings and pricing (including depreciation rate prescription), and a "make money" option in which the ILEC would accept a prescription of access rates at economic (TSLRIC) levels, but

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[29] The ETI study *Assessing ILEC Claims* shows relatively high market-to-book values for the ILECs, with RBHC shares trading at about two to three times book value, levels substantially higher than those for other gas and electric utilities). *Assessing ILEC Claims, op cit.,* pp. 18-19. These high market-to-book values indicate investor assessment of the ILECs is extremely favorable. Indeed, ETI's analysis shows that even after adjustments are made to the ILEC book value to offset the write-offs made by ILECs pursuant to SFAS 71, ILEC market to book values remain high. *Id.*, p. 19. These adjusted market-to-book values provide further evidence that investors clearly do not believe (as the Commission should not) ILEC rhetoric about the potential financial impact of competition or the erosion of earnings or capital recovery opportunities in the current regulatory environment.

with pricing flexibility and no regulatory restraints on earnings (including forbearance on depreciation ratesetting).

As the Ad Hoc Committee discussed in its recent comments in response to the Commission's October 5,1998 NPRM in CC Docket Nos. 96-262 and 94-1, the Commission cannot confer upon the ILECs the security of rate of return regulation (*i.e.*, guaranteed recovery of embedded costs) while concurrently granting them the pricing and earnings flexibility (and subject to this NPRM, the depreciation flexibility) enjoyed by non-regulated firms.[30] The Ad Hoc Committee's option-driven proposal would allow each ILEC to decide whether it or its ratepayers are to bear the risks and burdens and reap the rewards and benefits of the ILEC's investment decisions. Since an ILEC has the option of electing to be *made whole*, if it does not exercise that option, but instead chooses to *make money* under the unregulated earnings option, but then fails to recover its costs and embedded investment, it could not later claim an unlawful taking. What the ILECs are seeking is a paradigm in which they enjoy all of the protections traditionally provided under RORR while retaining all of the benefits of a price cap system with no sharing or earnings cap or, pursuant to the instant proceeding, no depreciation regulation either. Such a paradigm must be rejected as being fundamentally anti-competitive and unfair to ratepayers.

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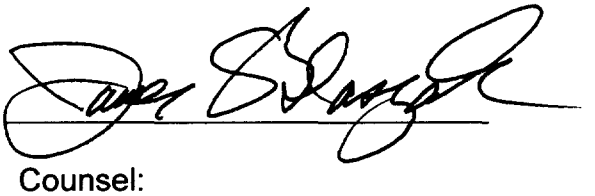
[30] *In the Matter of CC Docket No. 96-262, Access Charge Reform, Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, MCI Telecommunications Corp. Emergency Petition for Prescription, CC Docket No. 97-250, Consumer Federation of America Petition for Rulemaking, RM-9210,* Comments of the Ad Hoc Telecommunications Users Committee (Oct. 26, 1998) at 32.

CONCLUSION

In view of the foregoing, Ad Hoc urges the Commission to deny USTA's petition seeking Commission forbearance from regulating price cap LEC depreciation practices and rates, and to adopt depreciation policies consistent with the views set forth herein.

Respectfully submitted,



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Certificate of Service

I, Suzanne Takata, hereby certify that true and correct copies of the preceding Comments of the Ad Hoc Telecommunications Users Committee in CC Docket No. 98-137 were served this 23rd day of November, 1998 via electronic mail upon the following parties.

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